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Supreme Court, U. S.
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In the Supreme Court of the United States

OCTOBER TERM, 1979

UNITED STATES OF AMERICA, PETITIONER

v.

ELWOOD SWANK AND RITA SWANK

UNITED STATES OF AMERICA, PETITIONER

v.

BLACK HAWK COAL CORPORATION, INC.

UNITED STATES OF AMERICA, PETITIONER

v.

BULL RUN MINING CO., INC.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS

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INDEX

	Page
Opinion below	2
Jurisdiction	2
Question presented	2
Statutes and regulations involved	2
Statement	3
Reasons for granting the petition	8
Conclusion	18
Appendix A	1a
Appendix B	17a
Appendix C	23a

CITATIONS

Cases:

Bakertown Coal Co. v. *United States*, 485 F.2d 633 ..... 6, 7, 8, 9, 12, 13, 16
Commissioner v. *Southwest Exploration Co.*, 350 U.S. 308 ..... 10, 15, 16
Costantino v. *Commissioner*, 445 F.2d 405 8
Helvering v. *Bankline Oil Co.*, 303 U.S. 362 ..... 10, 11
Herring v. *Commissioner*, 293 U.S. 322 17
Holbrook v. *Commissioner*, 65 T.C. 415 8
Lewis v. *Reynolds*, 284 U.S. 281 15
McCall v. *Commissioner*, 312 F.2d 699 ..... 9, 15
Mullins v. *Commissioner*, 48 T.C. 571 8
Palmer v. *Bender*, 287 U.S. 551 ..... 10, 11
Paragon Jewel Coal Co. v. *Commissioner*, 380 U.S. 624 ..... 8, 13, 15, 16
Parsons v. *Smith*, 359 U.S. 215 ..... 8, 10, 13, 14, 15, 17

Cases—Continued

	Page
Ramey v. *Commissioner*, 47 T.C. 363, aff'd, 398 F.2d 478	9
Rissler & McMurry Co. v. *United States*, 480 F.2d 684	9
United States v. *Stallard*, 273 F.2d 847	9, 15
United States v. *Wade*, 381 F.2d 345	9
Usibelli v. *Commissioner*, 229 F.2d 539	9
Weaver v. *Commissioner*, 72 T.C. 594	8
Whitmer v. *Commissioner*, 443 F.2d 170	6, 8, 12, 13
Winters Coal Co. v. *Commissioner*, 57 T.C. 249	8

Statutes and regulations:

Internal Revenue Code of 1954 (26 U.S.C.):	
Section 611	2, 11
Section 611(a)	2, 10, 11, 23a
Section 612	10, 17
Section 613	2, 10, 11, 23a
Section 613(b)(4)	10
Section 613(c)	7
Section 631(c)	16, 17
Treasury Regulations on Income Tax (26 C.F.R.):	
Section 1.611-1	2, 24a
Section 1.611-1(a)(1)	10, 24a
Section 1.611-1(b)(1)	11, 24a

Miscellaneous:

G.C.M. 26290, 1950-1 Cum. Bull. 42	12
Rev. Rul. 70-277, 1970-1 Cum. Bull. 280	12
Rev. Rul. 77-481, 1977-2 Cum. Bull. 205	8, 9

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PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS

The Solicitor General, on behalf of the United States of America, petitions for a writ of certiorari to review the judgments of the United States Court of Claims in these cases.

OPINION BELOW

The opinion of the Court of Claims (App. A, *infra*, 1a-16a) is reported at 602 F.2d 348.

JURISDICTION

The judgments of the Court of Claims were entered on December 7, 1979 in *Bull Run Mining Co.* and *Black Hawk Coal Corporation*, and on November 30, 1979 in *Swank* (App. B, *infra*, 17a-22a). By order dated February 21, 1980, the Chief Justice extended the time within which to file a petition for a writ of certiorari to and including March 29, 1980. The jurisdiction of this Court is invoked under 28 U.S.C. 1255.

QUESTION PRESENTED

Whether a provision in a mineral lease permitting the lessor to terminate the lease on 30 days' notice without cause deprives the lessee of an economic interest in the minerals in place so that the lessee is not entitled to a depletion deduction under Sections 611 (a) and 613 of the Internal Revenue Code of 1954.

STATUTES AND REGULATIONS INVOLVED

The pertinent provisions of Sections 611 and 613 of the Internal Revenue Code of 1954 (26 U.S.C.), and of Treasury Regulations on Income Tax, Section 1.611-1 (26 C.F.R.), are set forth in Appendix C, *infra*, 23a-25a.

STATEMENT

1. a. *Swank.* During 1966-1967, respondent Swank[1] was engaged in mining anthracite coal on various tracts located in Northumberland County, Pennsylvania. Swank had leased these tracts from Northumberland County under lease agreements dated October 24, 1964 and July 25, 1966. Pursuant to the leases, Swank was authorized to mine coal on lands owned by the county in exchange for a royalty of 35 cents per gross ton of coal removed. Swank could sell the coal to whomever he pleased at whatever price he could obtain. Both leases contained provisions for automatic termination if either (1) the County sold the lands; (2) the tax delinquent former owners redeemed the lands; (3) the lessee failed to mine and remove coal for 30 consecutive days absent abnormal conditions; or (4) the lessee failed to comply with the terms of the lease agreement. Moreover, each lease provided, in accordance with the County's practice with respect to all leases negotiated between January 1, 1956 and May 31, 1969, that the lessor could "terminate this agreement completely and fully without liability upon it or any further recourse against it, upon thirty days written notice given to MINER * * *."[2] On his 1966 and 1967 federal income tax

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[1] References to Swank are to respondent Elwood Swank. Rita Swank is a party solely because she filed joint federal income tax returns with her husband for the years in issue.

[2] The Court of Claims found that it had been the publicly announced policy from 1956 that the Northumberland County Commissioners would not terminate a mining lease except

returns, Swank claimed a deduction for depletion of coal resources covered by the leases with the County of Northumberland (App. A, *infra*, 11a-12a; Finding Nos. 2, 3, 6, 8-12, 14).

b. *Black Hawk Coal Corporation.* During 1970-1972, respondent Black Hawk Coal Corporation was engaged in the mining of coal on lands located in Pike County, Kentucky. The lands in question were under a lease agreement dated February 20, 1964, between Kentland Coal & Coke Company, Division of the Berwind-White Coal Mining Company, as lessor, and Eugene M. Bane, as lessee. Bane in turn assigned the lease to respondent. Pursuant to the terms of that agreement, respondent, as lessee, was authorized to remove coal from specified lands for an unspecified term until the coal seam was exhausted, for a consideration of $5,000 per year, payable monthly, plus 25 cents per ton of coal removed. The latter amount was to be credited against the monthly royalty as rental. The lease agreement was terminable if respondent failed to pay the required rent or royalties for a period of 60 days after the due date of such payments, and was cancellable by either party without cause on 30 days' written notice. The agreement permitted respondent to sell the coal which it mined to anyone. On its federal income tax returns for 1970-1972, respondent claimed a percentage de-

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for cause because of the time and capital which a lessee would be expected to invest in mining operations. However, the Commissioners would not give any assurance that they could not cancel a lease without cause (Finding No. 15).

pletion deduction with respect to the coal which had been mined under the lease agreement (Stip. paras. 3, 6, 8, 10; Stip. Ex. 4, at 3).

c. *Bull Run Mining Co.* During its taxable year ended September 30, 1974, respondent Bull Run Mining Co., Inc. was engaged in mining coal in West Virginia, under a lease agreement, dated June 21, 1967, between it, as lessee, and Preston County Coal and Coke Corporation, as lessor. The lease was for a five-year term, which was thereafter extended for an additional five years. Pursuant to the terms of the lease, respondent was authorized to mine coal on specified lands for the payment of a monthly royalty of 25 cents per ton of coal removed. The lease agreement was cancellable by either party on 30 days' written notice. The lease gave the lessor the first opportunity to buy the coal mined by respondent at the current market price. The lessor exercised this right so that respondent sold all of the coal it mined during 1974 to the lessor. On its federal income tax return for its taxable year ended September 30, 1974, respondent claimed a depletion deduction with respect to the coal which it mined as lessee under the agreement (Bull Run Pet. paras. 3, 5; Bull Run Pet. Ex. A).

2. On audit of each of respondents, the Commissioner of Internal Revenue determined deficiencies in income taxes on the ground that none of them possessed a depletable economic interest in the minerals covered by the leases under which they were lessees. The Commissioner therefore disallowed respondents' claimed depletion deductions for the taxable years at

issue. After respondents paid the resulting assessments, they filed claims for refund, which the Commissioner denied. Respondents thereupon instituted these refund suits in the Court of Claims (App. A, *infra*, 3a). (Swank—Findings Nos. 4-5; Black Hawk Stip. paras. 11-14; Bull Run Mining Co.—Findings Nos. 10-13).

The Court of Claims consolidated all three cases for argument. It upheld respondents' claims for refund on the authority of its prior decision in *Bakertown Coal Co.* v. *United States*, 485 F.2d 633 (1973). There, on virtually identical facts, a divided en banc court held that lessees under comparable coal leases had an economic interest in the coal in place, thereby entitling them to the percentage depletion deduction for the coal mined. The Court of Claims adhered to its *Bakertown* decision, ruling that the fact that the lessors could have terminated the lease without cause did not deprive respondent lessees of an economic interest in the minerals in place and the depletion deduction (App. A, *infra*, 1a-10a). As the court saw the matter, "the mere existence of the unused termination clause is not enough to deprive the taxpayer-lessees of their 'economic interest' they would otherwise admittedly have" (App. A, *infra*, 5a). In so holding, the court acknowledged that its decision squarely conflicted with *Whitmer* v. *Commissioner*, 443 F.2d 170 (3d Cir. 1971) (App. A, *infra*, 5a-6a).

The Court of Claims further observed that even on the assumption that the lessor's legal right to terminate the lease (rather than whether there was an

actual termination) was determinative of the lessee's eligibility to the depletion deduction, it "[could] not say *a priori* [in the absence of any proof] that a month's period is too short for a miner to expect to extract a substantial amount of coal" (App. A, *infra*, 8a). In considering the effect of a termination clause, the court therefore concluded that "[l]ike *Bakertown*, these cases do not involve leases terminable within a single day" (*ibid.*).

Finally, as in *Bakertown* (see 485 F.2d at 642), the Court of Claims found persuasive the fact that if respondents' claimed depletion deductions were disallowed, there would be no depletion on the coal mined under these leases. Although the court acknowledged the correctness of the government's argument that every applicant for the depletion allowance must show his own entitlement, it nevertheless concluded "that Congress, in establishing percentage depletion, intended that, except for extraordinary instances, someone should be entitled to depletion on all mined coal covered by the Code provision. Cf. I.R.C. § 613(c)" (App. A, *infra*, 9a). As the court observed, "[w]here there can be no other claimant, we believe that neither the Internal Revenue Service nor the courts should be too technical or too harsh in finding the only possible applicant to be ineligible. The considerations are in some (though of course not all) respects different from the cases in which a choice has to be made among competing claimants" (*ibid.*).

REASONS FOR GRANTING THE PETITION

1. In holding that a provision in a mineral lease permitting the lessor to terminate the lease on 30 days' notice without cause did not defeat the lessee's claim to a depletion deduction, the Court of Claims both here (App. A, *infra*, 5a-6a) and in its previous opinion in *Bakertown Coal Co.* v. *United States*, 485 F.2d 633, 640-641 (1973), acknowledged that its decision squarely conflicted with *Whitmer* v. *Commissioner*, 443 F.2d 170 (3d Cir. 1971). There, on identical facts, the Third Circuit rejected the lessee's claimed depletion deduction, observing that "[s]uch right on the part of the lessor to terminate would appear to be fatal to a lessee's ability to claim the depletion deduction because no right to extract until exhaustion of the coal has been granted" (443 F.2d at 173). Accord: *Costantino* v. *Commissioner*, 445 F.2d 405, 409 (3d Cir. 1971) (30-day termination); *Mullins* v. *Commissioner*, 48 T.C. 571 (1967) (60-day termination); *Winters Coal Co.* v. *Commissioner*, 57 T.C. 249 (1971) (30 and 60-day termination), rev'd on other grounds, 496 F.2d 995 (5th Cir. 1974); *Holbrook* v. *Commissioner*, 65 T.C. 415 (1975) (30-day termination); *Weaver* v. *Commissioner*, 72 T.C. 594, 606-609 (1979) (immediate termination); Rev. Rul. 77-481, 1977-2 Cum. Bull. 205.

Similarly, in conformity with this Court's decisions in *Parsons* v. *Smith*, 359 U.S. 215, 224-225 (1959), and *Paragon Jewel Coal Co.* v. *Commissioner*, 380 U.S. 624, 633 (1965), both the Fourth and Fifth Circuits have expressed the view that the lessor's

right to terminate a mineral lease on short notice is a significant factor in determining the lessee's entitlement to a depletion deduction. *United States* v. *Stallard*, 273 F.2d 847 (4th Cir. 1959); *McCall* v. *Commissioner*, 312 F.2d 699 (4th Cir. 1963); *United States* v. *Wade*, 381 F.2d 345 (5th Cir. 1967). See also *Ramey* v. *Commissioner*, 47 T.C. 363, 375 (1967), aff'd, 398 F.2d 478 (6th Cir. 1968); *Usibelli* v. *Commissioner*, 229 F.2d 539 (9th Cir. 1955); *Rissler & McMurry Co.* v. *United States*, 480 F.2d 684 (10th Cir. 1973).

Moreover, since the Court of Claims' prior decision in *Bakertown Coal Co.*,[3] the effect of a short notice termination clause in a mineral lease upon the lessee's entitlement to the depletion deduction has assumed greater administrative importance. We are advised by the Internal Revenue Service that there are currently 15 cases pending administratively either on audit or at the appellate level, or in the district courts, with approximately $2,176,383 of revenue at stake. Since the Service has announced that it will not follow *Bakertown Coal Co.* (see Rev. Rul. 77-481, *supra*), the impact of the decision below upon the revenue can be expected to increase. This Court should now put to rest the uncertainty engendered by the conflict of decisions and establish a uniform rule to guide both the Internal Revenue Service and those who enter into mineral leasing arrangements.

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[3] We did not petition for a writ of certiorari in *Bakertown* because of doubt at that time whether the decision would have sufficient continuing importance to warrant this Court's review.

2. Section 611(a) of the Code (App. C, *infra*, 23a) provides that "[i]n the case of mines, oil and gas wells, other natural deposits, and timber, there shall be allowed as a deduction in computing taxable income a reasonable allowance for depletion * * * according to the peculiar conditions in each case * * *." As this Court has declared many times, the depletion deduction "is permitted in recognition of the fact that the mineral deposits are wasting assets and is intended as compensation to the owner for the part used up in production." *Helvering* v. *Bankline Oil Co.*, 303 U.S. 362, 366 (1938). Thus, the deduction is "designed to permit a recoupment of the owner's capital investment in the minerals so that when the minerals are exhausted, the owner's capital is unimpaired." *Commissioner* v. *Southwest Exploration Co.*, 350 U.S. 308, 312 (1956). "In short, the purpose of the depletion deduction is to permit the owner of a capital interest in mineral in place to make a tax-free recovery of that depleting capital asset." *Parsons* v. *Smith*, 359 U.S. 215, 220 (1959).[4]

In response to the variety of financial arrangements employed in the extraction of minerals, this Court almost 50 years ago in *Palmer* v. *Bender*, 287 U.S.

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[4] Pursuant to Treasury Regulations, Section 1.611-1(a)(1) (App. C, *infra*, 24a), the depletion deduction is computed on the basis of cost (Section 612) or upon the basis of a specified percentage of the gross income from the property (Section 613), whichever results in the greater allowance for any taxable year. Section 613(b)(4) permits a percentage depletion deduction of ten percent with respect to coal.

551 (1933), developed the "economic interest" test for determining what interests in mineral deposits were permitted a depletion deduction under the practically identical statutory predecessors of Sections 611 and 613. As the Court there stated, "[t]he language of the statute is broad enough to provide, at least, for every case in which the taxpayer has acquired, by investment, any interest in the oil in place, and secures, by any form of legal relationship, income derived from the extraction of the oil, to which he must look for a return of his capital." The Court further said that the deduction is not "dependent upon the particular legal form of the taxpayer's interest in the property to be depleted, [and that] [i]t is enough if * * * he has retained a right to share in the oil produced. If so he has an *economic interest* in the oil, in place, which is depleted by production" (emphasis added) (287 U.S. at 557). Accord: Treasury Regulations, Section 1.611-1(b)(1) (26 C.F.R.) (App. C, *infra*, 24a).

Subsequently, in *Helvering* v. *Bankline Oil Co.*, 303 U.S. 362 (1938), the Court refined the "economic interest" concept. It observed that "* * * the phrase 'economic interest' is not to be taken as embracing a mere economic advantage derived from production, through a contractual relation to the owner, by one who has no capital investment in the mineral deposit" (*id.* at 367). Applying that principle to the facts of that case, the Court held that a processor who acquired the right to take gas from the wellheads and to extract and sell gasoline therefrom, paying the well

owners a percentage of the proceeds of such sales, had not acquired an economic interest in the depleting gas in place but only an economic advantage to be derived from the processing operations, so that the processor was not eligible for the depletion deduction.

The decision of the Court of Claims in the instant case, and in *Bakertown Coal Co.* to which it adhered (App. A, *infra*, 5a), reflects a fundamental misconception of this Court's "economic interest" test. As we have pointed out (*supra*, pages 10-11), a taxpayer claiming a depletion deduction must have an economic interest in the minerals in place. But given the lessor's right to terminate the leases in these cases on 30 days' notice, without cause, it is difficult to imagine what kind of "economic interest" respondents could be said to have acquired in the minerals in place. Respondents' right to mine the coal was completely subject to the will of their lessors who could have forced them to abandon their ventures on short notice if the lessors found the leases to be unprofitable or disadvantageous in light of changing market conditions. In these circumstances, it is the lessors who have the economic interest in the coal in place, and respondents cannot claim a right to exhaust either the entire coal deposits, or any particular substantial part of it. See G.C.M. 26290, 1950-1 Cum. Bull. 42, declared obsolete, Rev. Rul. 70-277, 1970-1 Cum. Bull. 280. Respondents' mining rights were entirely subordinate to the lessors' right to terminate the arrangement at will, on 30 days' notice. As the Third Circuit observed in *Whitmer* v. *Commissioner*, *supra*, 443

F.2d at 173, "[s]uch right on the part of the lessor to terminate would appear to be fatal to a lessee's ability to claim the depletion deduction because no right to extract until exhaustion of the coal has been granted."

Moreover, the analysis of the Third Circuit in *Whitmer* is entirely in accord with this Court's appraisal of the effect of the lessor's right to terminate on short notice upon the lessee's entitlement to a depletion deduction. Thus, in *Parsons* v. *Smith*, *supra*, this Court affirmed two decisions of the Third Circuit (255 F.2d at 595; *id.* at 597) disallowing the lessees' claimed depletion deductions where "the contracts were completely terminable without cause on short notice" (359 U.S. at 225). In so holding, the Court necessarily rejected the view of the dissenting judge in the court of appeals (upon that court's denial of rehearing en banc) that "the right of termination does not affect a stripper's right to depletion where the requisite economic interest as defined by the Supreme Court exists" (255 F.2d at 602). See also *Paragon Jewel Coal Co.* v. *Commissioner*, 380 U.S. 624, 634-636 (1965).

3. a. In *Bakertown Coal Co.* v. *United States*, *supra*, the Court of Claims acknowledged that this Court in *Parsons* v. *Smith*, *supra*, accorded significant weight to the lessor's right to terminate on short notice without cause in ruling that the lessee was thereby deprived of an economic interest in the minerals in place. However, the Court of Claims refused to ascribe controlling weight to the lessor's right to terminate at will. As it saw the matter, "[t]hough

terminability was one of the seven disqualifying factors mentioned [in *Parsons* v. *Smith*, *supra*], it cannot be considered either in isolation or in the abstract, as the Government would have it" (485 F.2d at 639). In the Court of Claims' view, "the matter of terminability becomes only a colorably relevant factor where the applicant for the allowance lacks the traditional qualifications for depletion, as reflected by the other six conditions referenced by the court" (*ibid.*).[5] The Court of Claims therefore distinguished *Parsons* v. *Smith*, *supra*, on the ground that there "the coal

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[5] In *Parsons* v. *Smith*, *supra*, 359 U.S. at 215, the Court enumerated seven factors in support of its decision rejecting miners' contractors' claims to depletion deductions. The Court cited the facts (*id.* at 225)—

> (1) that petitioners' investments were in their equipment, all of which was movable—not in the coal in place; (2) that their investments in equipment were recoverable through depreciation—not depletion; (3) that the contracts were completely terminable without cause on short notice; (4) that the landowners did not agree to surrender and did not actually surrender to petitioners any capital interest in the coal in place; (5) that the coal at all times, even after it was mined, belonged entirely to the landowners, and that petitioners could not sell or keep any of it but were required to deliver all that they mined to the landowners; (6) that petitioners were not to have any part of the proceeds of the sale of the coal, but, on the contrary, they were to be paid a fixed sum for each ton mined and delivered, which was, as stated in *Huss*, agreed to be in "full compensation for the full performance of all work and for the furnishing of all [labor] and equipment required for the work"; and (7) that petitioners, thus, agreed to look only to the landowners for all sums to become due them under their contracts.

company was bound to pay the contractors the posted fee regardless of the condition of the market at the time of delivery and, thus, that the contractors did not look to the sale of the coal for a return of their investment but looked solely to the coal company" (485 F.2d at 640).

To be sure, the Court of Claims correctly concluded that the mining contractors in *Parsons* v. *Smith*, *supra*, "were equally deficient under each of the six other criteria set forth by the Supreme Court." See also *Paragon Jewel Coal Co.* v. *Commissioner*, *supra*; *United States* v. *Stallard*, *supra*; *McCall* v. *Commissioner*, *supra*. But this purported distinction ignores this Court's admonition, made in the context of another depletion case, that "the tax law deals in economic realities, not legal abstractions." *Commissioner* v. *Southwest Exploration Co.*, 350 U.S. 308, 315 (1956). If the market price of the minerals rises above the lessor's royalty, the lessor will assuredly exercise his right to terminate the lease on short notice and will either enter into a more profitable lease or extract the mineral himself and sell it. In these circumstances, the terminability on short notice [6] gives the

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[6] The Court of Claims also held that, even if the lessor's right to terminate the lease were determinative, the court could not say, in the absence of proof, that 30 days was too short a period for the lessee to extract a substantial amount of coal (App. A, *infra*, 8a). But this refund suit is analogous to an action for money had and received. Hence, respondents bore the burden of proof that they overpaid their taxes and were entitled to a refund of a particular amount. *Lewis* v. *Reynolds*, 284 U.S. 281 (1932). The absence of proof should therefore redound to respondents' detriment, and not to the

lessor the powerful right to assume complete and unfettered dominion over the mineral deposit, *viz.*, an economic interest in the minerals in place. The unexercised termination clause therefore has profound economic significance, rather than, as the decision below erroneously concluded (App. A, *infra*, 5a), "mere existence."

b. Finally, there is no basis for the Court of Claims' observation, made both in the instant case (App. A, *infra*, 9a) and in *Bakertown Coal Co.* v. *United States*, *supra*, 485 F.2d at 642, that if respondents are not entitled to the depletion deduction, "there will be no depletion on the coal mined under these leases" (App. A, *infra*, 9a). The court apparently believed this conclusion to follow from the fact that "[u]nder the express terms of Section 631(c) of the 1954 Code, the lessors are 'relegated to capital gains treatment of the royalties received' *Paragon Jewel Coal Co.* v. *Commissioner*, *supra*, 380 U.S. at 636 * * *" (485 F.2d at 642).

But the capital gains treatment to which the lessors would be entitled under Section 631(c) does not deprive them of the benefits of depletion, which "is designed to permit a recoupment of the owner's capital investment in the minerals so that when the minerals are exhausted, the owner's capital is unimpaired." *Commissioner* v. *Southwest Exploration Co.*, *supra*,

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government's. At all events, the question is not whether respondents could extract a substantial amount of coal in 30 days, but whether they could extract a substantial portion of the deposits in that period. See G.C.M. 26230, *supra*.

350 U.S. at 312. The special capital gains rule of Section 631(c) applies only when the "owner retains an economic interest in such coal * * *." In these circumstances, the owner fully recoups his capital investment in the minerals and thereby obtains the benefits of depletion by measuring his gain by "the difference between the amount realized from the disposal of such coal * * * and the adjusted depletion basis thereof * * *." While the lessor will not ratably recover his basis through percentage depletion, the subtraction of his adjusted depletion basis in measuring his gain insures that he will "make a tax-free recovery of that depleting capital asset" (*Parsons* v. *Smith*, *supra*, 359 U.S. at 220) under the cost depletion method (Section 612). See *Herring* v. *Commissioner*, 293 U.S. 322, 327-328 (1934). Accordingly, the lessor and not the lessee is entitled to the depletion deduction.

As matters now stand, it is plain that if the conflict between the Court of Claims and the Third Circuit persists, the parties to mineral leases will continue to be uncertain as to who has the economic interest in the minerals in place and obtains the benefits of the depletion deduction. Since the consideration for such arrangements rests in large part upon their tax consequences, fairness to both lessors and lessees requires a settled rule governing these leases that would guide their negotiations and be binding on the Internal Revenue Service. Review by this Court is therefore warranted.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted.

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MARCH 1980

APPENDIX A

IN THE UNITED STATES COURT OF CLAIMS

(Decided July 18, 1979)

No. 403-75

ELWOOD SWANK AND RITA SWANK

v.

THE UNITED STATES

Lloyd R. Persun, attorney of record, for plaintiffs. *Howell C. Mette* and *Shearer, Mette & Woodside*, of counsel.

James L. Malone, III, with whom was *Assistant Attorney General M. Carr Ferguson*, for defendant. *Theodore D. Peyser* and *Robert S. Watkins*, of counsel.

ON DEFENDANT'S EXCEPTIONS TO THE TRIAL JUDGE'S DECISION

No. 49-77

BLACK HAWK COAL CORPORATION, INC.

v.

THE UNITED STATES

LeRoy Katz, attorney of record, for plaintiff. *Katz, Kantor, Katz, Perkins & Cameron*, and *Richard L. Hirshberg*, of counsel.

James L. Malone, III, with whom was *Assistant Attorney General M. Carr Ferguson*, for defendant. *Theodore D. Peyser, Robert S. Watkins* and *Judith H. Johnson*, of counsel.

ON STIPULATION OF FACTS

No. 400-77

BULL RUN MINING CO., INC.

v.

THE UNITED STATES

Woodrow A. Potesta, attorney of record, for plaintiff.

James L. Malone, III, with whom was *Assistant Attorney General M. Carr Ferguson*, for defendant. *Theodore D. Peyser, Robert S. Watkins* and *Jo-Ann Horn*, of counsel.

ON PLAINTIFF'S MOTION FOR SUMMARY JUDGMENT AND DEFENDANT'S CROSS MOTION FOR SUMMARY JUDGMENT

Before DAVIS, KASHIWA, and BENNETT, *Judges*.

PER CURIAM: These three tax refund suits, consolidated for argument, all present the single question of whether a provision in a coal-mining lease permitting termination by either party (or by the lessor alone) on 30 days' notice precludes the plaintiff-lessees from having an "economic interest" in the coal in place which would entitle them to a percentage allowance for depletion under sections 611 and 613 of the Internal Revenue Code of 1954. The Government admits that, in the absence of this 30-day termination provision, the lessees would all be entitled to such a depletion allowance.[1]

Though they all involve the single issue we have stated, the cases come before the court in different ways and concern different tax years. No. 403-75, involving 1966 and 1967, was tried before Trial Judge Bernhardt who has rendered his decision that plaintiffs are entitled to recover. No. 49-77, involving 1970-1972, is before us on a stipulation of facts. No. 400-77, involving fiscal 1974, comes to us on cross-motions for summary judgment. It is unnecessary to

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[1] In No. 403-75, there was a slight suggestion by the defendant in its briefs that in any event the particular terms of those leases precluded those plaintiffs from having a sufficient "economic interest" (apart from the termination clause), but, on inquiry, this contention was not pressed at the oral argument—and in any case we reject it.

set forth here the individual facts because for present purposes the cases are legally all the same.[2]

Each taxpayer held a lease (or leases) of coal-bearing property with unstated duration or duration for a term of years—subject to the termination clause or clauses. These leases provided for royalties (plus, in at least one of the cases, a flat annual rent) to be paid by the lessee [3] and gave him the right to extract coal and to sell it to whomever and at whatever price he chose.[4] Each lease contained a clause permitting either party (or the lessor alone) to terminate the lease (and operations thereunder), apparently without cause, within thirty days. In each case the plaintiffs mined coal under these leases during the taxable years and for a substantial time before. The proceeds from the sales of the coal represented the sole source of revenue from which the lessees could recover any rents and royalties paid to the lessor for the right to mine.

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[2] In No. 403-75 the court adopts the trial judge's findings of fact though they are not printed herewith. In No. 49-77 we adopt the parties' stipulation of facts as the court's findings of fact. In No. 400-77 the relevant facts are not in dispute and this opinion reflects such facts as are necessary to sustain our disposition of the cross-motions for summary judgment.

[3] The rents and royalties were not tied to the prices received by the lessees from the coal.

[4] In No. 400-77, the lessor had the right of first purchase but only if it met plaintiff-lessee's price. The lessee could always sell to another at a price higher than the lessor was willing to pay.

On these facts, as defendant recognizes (and as Trial Judge Bernhardt held in No. 403-75), the cases are each governed by our decision in *Bakertown Coal Co.* v. *United States*, 202 Ct. Cl. 842, 485 F.2d 633 (1973), which presented the identical issue on facts practically the same as those now before us. This panel cannot, under this court's practice, depart from that holding. *See Dravo Corp.* v. *United States*, 219 Ct. Cl. —— (slip op. at 2), 594 F.2d 842, 843 (1979). Nor have we been persuaded that *Bakertown* was wrongly decided or that we should ask the court *en banc* to reconsider the issue.[5]

The Government picks at this or that aspect of the *Bakertown* opinion, but the core holding of that case remains—that coal-mining lessees with leases like those in *Bakertown* (and in these cases) have an "economic interest" in the coal, entitling them to percentage depletion for the coal mined during the taxable years, even though those leases could theoretically and legally have been terminated by the lessor, without cause, on 30 days' notice; the mere existence of the unused termination clause is not enough to deprive the taxpayer-lessees of their "economic interest" they would otherwise admittedly have. Except for *Whitmer* v. *Commissioner*, 443 F.2d 170 (3rd Cir. 1971)—with which the *Bakertown* court expressly

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[5] It has some significance to us that, since *Bakertown*, the Treasury Department has not modified the relevant regulation which continues to speak only in very general terms so as to exclude from the depletion deduction terminable leases like those involved here.

disagreed—we know of no Supreme Court or Court of Appeals holding in conflict with this ruling of *Bakertown.*

Defendant says that *Bakertown* over-stressed the difference between true coal-lessees and coal contract-miners, and that the name or legal form of the mining arrangement is immaterial in determining "economic interest." We are told that what is important in appraising whether the taxpayer has acquired by investment such an interest in the coal in place is whether that taxpayer has, and can have, an adequate expectation at the beginning of the arrangement (or perhaps of the taxable year) that he will be permitted to mine to exhaustion or at least to mine a substantial amount of the coal,[6] and therefore will be able to appraise both his interest in the coal in place and what portion of that interest he has extracted during the taxable period. This need for advance calculation follows, defendant says, from the historical fact that percentage depletion was introduced as a substitute method of calculation for discovery depletion; on the Government's premise, in all the methods of depletion the taxpayer, to be entitled to the deduction, has to be able to estimate in advance his full interest in the minerals in place so that he can determine (at least roughly) what part he has actually taken out of the ground during the particular

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[6] GCM 26290, 1950-1 CUM. BULL. 42, considers this expectation to be solid enough where the contract cannot be terminated without cause within less than one year.

period. With the 30-day cancellation clause, the argument goes, the coal miner or lessee cannot make such an advance estimate because he has and can have no such expectation beyond a month's time.

Even were we to accept defendant's premise that leases are no different for our purposes from mere contract mining arrangements, we could not deny depletion to the present taxpayers. For the records in these cases (as in *Bakertown*) show that each of the taxpayers had regularly mined coal from the leases in question for a very substantial period prior to the taxable years[7] and that, in all reality, they had a very good expectation of being able to continue to do so. In Nos. 403-75 and 400-77, we accept the showing that the lessors rarely (if ever) terminated without cause, not as demonstrating that the lessors lacked the legal power to terminate without cause,[8] but solely as showing that in practice and in reality the plaintiff coal-lessees had, at all relevant times, a solid expectation that they could continue under their leases to mine the coal for a substantial period and to extract a substantial amount of the coal.[9] This means—

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[7] In each instance more than the one-year period cited as sufficient in GCM 26290, *supra*, note 6.

[8] In No. 403-75 plaintiffs' claim to the judges that the leases could only be terminated for cause is precluded by the trial judge's findings that no such assurance was ever given, and that the reasonable interpretation of the termination clause permitted termination without cause. Plaintiffs failed to except to those findings.

[9] We were told at oral argument by counsel for one of the plaintiffs that lessors have not terminated, even though the

unless we are to depart from defendant's own norm for testing "economic interest" by substance and reality, rather than by mere nomenclature or the theoretical form of the legal arrangement—that taxpayers are entitled to depletion. They satisfy the proffered criterion of knowing in advance that they will be able to mine for a substantial period and to extract a substantial portion of the coal. Certainly this was true at the beginning of each of the taxable years.

If, however, we must look (contrary to the theme of the Government's presentation) only to the theoretical and legal right of the lessor to cancel within 30 days as if there was such a real possibility every month.[10] We cannot say *a priori* that a month's period is too short for a miner to expect to extract a substantial amount of coal. There is no such proof before us and we do not believe it is a matter of judicial notice. Like *Bakertown*, these cases do not involve leases terminable within a single day.

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value of coal has increased markedly in the recent past and the royalties fixed in the leases now seem "outdated," because, for a new lessee, the costs of continuing with an existing mine are usually so great, comparatively, that it is difficult for a lessor to obtain new lessees at terms more favorable to the lessors than the existing leases. We do not accept this as evidence, but the record contains nothing to contradict this explanation for what seems to be the fact that leases of this type have not been regularly cancelled by lessors in recent years.

[10] And if contrary to *Bakertown*, that termination right were all-important and all-determinative even in the case of a true lease.

Finally, we reiterate what was said in *Bakertown*, 202 Ct. Cl. at 857, 485 F.2d at 642, about the non-availability in these cases of the depletion allowance to the lessors or anyone else. If plaintiffs are not entitled, there will be no depletion on the coal mined under these leases. The Government insists that every applicant for the allowance must show his own entitlement. We agree, but think that Congress, in establishing percentage depletion, intended that, except for extraordinary instances, someone should be entitled to depletion on all mined coal covered by the Code provision. *Cf.* I.R.C. § 613(c). Where there can be no other claimant, we believe that neither the Internal Revenue Service nor the courts should be too technical or too harsh in finding the only possible applicant to be ineligible. The considerations are in some (though of course not all) respects different from the cases in which a choice has to be made among competing claimants.

Conclusion

For these reasons, we conclude as follows:

(a) In No. 403-75, we adopt the trial judge's opinion (and set it forth *infra*) and his findings, and on that basis, as well as on the foregoing *per curiam* opinion, we hold that plaintiffs are entitled to recover taxes and interest assessed, plus interest as provided by law.

(b) In No. 49-77, on the basis of the stipulated facts and the foregoing *per curiam* opinion, we hold

that plaintiff is entitled to recover taxes and interest assessed, plus interest as provided by law.

(c) In No. 400-77, we grant plaintiff's motion for summary judgment and deny defendant's cross-motion, for summary judgment, and hold that plaintiff is entitled to recover interest and taxes assessed, plus interest as provided by law.

(d) In each case, the amount of recovery will be determined pursuant to Rule 131(c).

OPINION OF TRIAL JUDGE IN NO. 403-75

BERNHARDT, *Trial Judge*: In *Bakertown Coal Co.* v. *United States*, 202 Ct. Cl. 842, 485 F.2d 633 (1973), the court held, contrary to the sense of *Whitmer* v. *Commissioner*, 28 T.C.M. (CCH) 1480 (1969), *aff'd*, 443 F.2d 170 (3d Cir. 1971), that a lessee of coal-bearing property whose lease provided a bilateral 30-day termination notice and a tonnage royalty for rent, and allowed a vesting of ownership by the lessee in the coal as mined with the right to extract and sell it to whomever and at whatever price he chose, acquired an economic interest in the coal in place sufficient to earn a depletion deduction under Section 611(a) of the Internal Revenue Code of 1954, *as amended*. Despite the virtual identity of the facts in the present case with those in *Whitmer*, which held against the taxpayer, there is such comparability in significant legal principle to this court's opinion in *Bakertown* that a judgment for the plaintiff tax-

payer [1] is required. Conflict between *Bakertown* and *Whitmer* is basic. The Tax Court has been consistent. See *Mullins* v. *Commissioner*, 48 T.C. 571 (1967), and *Winters Coal Co.* v. *Commissioner*, 57 T.C. 249 (1971). More recently *Bakertown* was followed in *Thornberry Constr. Co.* v. *United States*, 217 Ct. Cl. , 576 F.2d 346 (1978), so this court has also been consistent in its difference.

During 1966 and part of 1967 the plaintiff, an independent coal mine operator, leased from Northumberland County, Pennsylvania, and mined coal from, two properties of which, *inter alia*, the county had acquired title at sales for delinquent taxes. The leases, which were on a standard form in use by the county for a number of years, and were for an unstated duration until termination, provided for the payment of 35¢ per ton royalties, for termination by the county on specified grounds, and for termination by the county without cause on 30 days written notice. Both plaintiff and a representative of the county testified, over defendant's objection, that the county had never—and would not—terminate a coal lease without cause. One of the properties had been leased previously by the county to one Gusick, to whom plaintiff paid $12,085 for equipment and an existing excavation, and the other was a strip mining operation on land which had not been previously worked. Plaintiff paid $6,500 to construct an access road to

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[1] The term "plaintiff" shall refer to both husband and wife as an entity.

the strip mine. A third property had also been leased by plaintiff from the county for deep mining, also succeeding a prior lessee to whom plaintiff had paid money for equipment and an excavation, but plaintiff never extracted any coal pursuant to the deep mining lease because he did not have the miners to operate the mine, so the lease was terminated for this failure in November 1969. Plaintiff had paid $118,477.27 for the acquisition and improvement of a tipple [2] from 1959 to 1966. In 1962 or 1963 he had paid $10,000 for a railroad siding near the breaker. He had also purchased $373,123.83 worth of equipment for use in his mining operations, but there is no way of allocating this cost between plaintiff's mining business and a trucking business which he also had, nor of allocating the cost to the two mines in suit is distinguished from its use in the processing of coal purchased from other mines. Plaintiff paid Northumberland County royalties in 1966 and 1967 for production of coal from the two leased mines which he operated, and sold the excavated coal to buyers of his choice and at prices he fixed. He claimed deductions in his 1966 and 1967 income tax returns for depletion of his economic interest in the coal in place under his two leases. Upon disallowance of the deductions by the IRS plaintiff paid tax deficiencies of $30,586.84 under protest, together with interest of $3,663, which he now seeks to recover.

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[2] A device for breaking, cleaning, and sorting coal, located within convenient distance from the mines.

Section 611(a) of the Code authorizes "a reasonable allowance for depletion" of mineral deposits under regulations prescribed by the Secretary. Treas. Reg. § 1.611-1(b) (1970) limits the depletion deduction to the owner of an economic interest in the mineral in place acquired by capital investment, and distinguishes a depletable economic interest from a mere economic or pecuniary advanatge such as a contract right to purchase the mineral product from the owner of an economic interest, or the right to compensation for services in extracting minerals.

The defendant labors the false issue of parol evidence admitted at trial over objection to show that for over a decade it was the unbroken practice of Northumberland County to terminate its coal leases only for cause, the clear term of the standard lease form to the contrary notwithstanding. Under the identical lease form in *Whitmer, supra,* the Tax Court —seemingly without demur from defendant—received much the same parol evidence that was offered and received here, and nevertheless held that the express provision of the lease as to short termination notice precluded an economic interest by the lessee in the coal in place. On appeal the Circuit Court held the parol evidence inadmissible. 443 F.2d at 173. *Bakertown* which involved no such parol evidence, held that the lessee's property interest "is not varied or diminished simply because the authority is subject to the possibility of extinction in the future by a termination of the leases on short notice." *Bakertown, supra,* 202 Ct. Cl. at 847-48, 485 F.2d at 636.

While, because of *Bakertown*, the immediate case does not require consideration of the parol evidence that was received, it should be observed in passing that the rule that parol evidence cannot be admitted to vary, explain, or contradict a writing is available primarily to the parties to the writing and not to a stranger, such as the government in this instance. 30 AM. JUR. 2d §§ 1029-31; 3 A. CORBIN ON CONTRACTS, § 596 (1960 ed.); *Mustard* v. *United States*, 140 Ct. Cl. 205, 216, 155 F. Supp. 325, 332 (1957); *Smith* v. *Commissioner*, 324 F.2d 725, 726 (9th Cir. 1963); *Thorsness* v. *United States*, 260 F.2d 341, 345 (7th Cir. 1958).

Since the nature of "economic interest" was expounded in *Palmer* v. *Bender*, 287 U.S. 551 (1933), it has become commonplace in tax opinions. *Filtrol Corp.* v. *United States*, 203 Ct. Cl. 32, 35, 487 F.2d 536, 538 (1973). *Palmer* limits the right to depletion to the taxpayer who "has acquired, by investment, any interest in the oil in place", and who "secures, by any form of legal relationship, income derived from the extraction of the oil, to which he must look for a return of his capital." *Id.*, 287 U.S. at 557. The economic interest of the lessee exists independent of the lessor's legal title to the oil [or other mineral] in place. *Lynch* v. *Alworth-Stephens Co.*, 267 U.S. 364 (1925); *National Steel Corp.* v. *United States*, 176 Ct. Cl. 952, 966, 364 F.2d 375, 382-83 (1966). The taxpayer's investment in depreciable equipment is not a factor in the concept of a depletable eco-

nomic interest in the coal. *Parsons* v. *Smith*, 359 U.S. 215 (1959). The lessee's right under his lease to convert the lessor's legal title to minerals in place to his own possession by their severance constitutes a very real economic interest in the mineral in place which depletes as the minerals are extracted. To exemplify by contrast, a lessee who, as a mining contract rather than a mine operator, contracts for compensation to extract minerals for the lessor, acquires no economic interest in the minerals in place, and hence cannot claim a depletion deduction. *Parsons* v. *Smith, supra; Paragon Jewel Coal Co.* v. *Commissioner*, 380 U.S. 624 (1965); *United States* v. *Stallard*, 273 F.2d 847 (4th Cir. 1959); *McCall* v. *Commissioner*, 312 F.2d 699 (4th Cir. 1963); *United States* v. *Wade*, 381 F.2d 345 (5th Cir. 1967).

The dissent in *Bakertown, supra*, 202 Ct. Cl. at 859, 485 F.2d at 643, suggests that plaintiff could not have had an economic interest if the lessor could terminate at will whenever the market price of coal increased. *Bakertown* involved a private lessor, whereas in the instant case the lessor is Northumberland County, a governmental entity which, unlike a private owner, was interested more in insuring that its coal lands were being actively mined than in the amount of income obtained. As proof of this interest the county never changed the royalty fee in its leases from 1956 through May 31, 1969. Plaintiff knew this.

In *Thornberry Constr. Co.* v. *United States, supra,* the coal mining lease required the lessee to first offer the mined coal to a third party on pain of termination, but left the price to be set by the lessee and permitted it to sell to others after the third party's requirements were met. Independent of the fact that termination was only for cause, this court held that the lessee had a depletable economic interest because, as in *Palmer, supra,* it looked solely to the income derived from the extraction of coal for a return of its capital.

Defendant's denial of a depletion allowance was erroneous. Plaintiff is entitled to recover taxes and interest assessed because of the erroneous denial, plus interest as provided by law. The amount of plaintiff's recovery should be determined pursuant to Rule 131(c)(2).

APPENDIX B

IN THE UNITED STATES COURT OF CLAIMS

No. 403-75

[Filed Nov. 30, 1979]

ELWOOD SWANK AND RITA SWANK

v.

THE UNITED STATES

ORDER

On July 18, 1979, the court rendered an opinion holding that the plaintiffs were entitled to recover and entering judgment to that effect. The determination of the amount of recovery was reserved pending further proceedings pursuant to Rule 131(c)(2).

On November 26, 1979, the trial judge of this court filed a memorandum report recommending that, in accordance with the opinion of the court and the stipulation of the parties, judgment be entered for the plaintiffs of $35,806.07, plus statutory interest, which recommendation is adopted by the court.

IT IS THEREFORE ORDERED that judgment be and the same is entered for the plaintiffs of thirty-

five thousand eight hundred six dollars and seven cents ($35,806.07), plus statutory interest.

BY THE COURT

/s/ Daniel M. Friedman
DANIEL M. FRIEDMAN
Chief Judge

IN THE UNITED STATES COURT OF CLAIMS

No. 49-77

[Filed Dec. 7, 1979]

BLACK HAWK COAL CORPORATION, INC.

v.

THE UNITED STATES

ORDER

On July 18, 1979, the court rendered an opinion holding that the plaintiff was entitled to recover and entering judgment to that effect. The determination of the amount of recovery was reserved pending further proceedings pursuant to Rule 131(c)(2).

On December 4, 1979, the trial judge of this court filed a memorandum report recommending that, in accordance with the opinion of the court and the stipulation of the parties, judgment be entered for the plaintiff of $164,141.03, plus statutory interest, which recommendation is adopted by the court.

IT IS THEREFORE ORDERED that judgment be and the same is entered for the plaintiff of one hundred sixty-four thousand one hundred forty-one dol-

lars and three cents ($164,141.03), plus statutory interest.

BY THE COURT

/s/ Daniel M. Friedman
DANIEL M. FRIEDMAN
Chief Judge

IN THE UNITED STATES COURT OF CLAIMS

No. 400-77

[Filed Dec. 7, 1979]

BULL RUN MINING CO., INC.

v.

THE UNITED STATES

ORDER

On July 18, 1979, the court rendered an opinion holding that the plaintiff was entitled to recover and entering judgment to that effect. The determination of the amount of recovery was reserved pending further proceedings pursuant to Rule 131(c).

On November 28, 1979, the trial judge of this court filed a memorandum report recommending that, in accordance with the opinion of the court and the stipulation of the parties, judgment be entered for the plaintiff for $20,960.43, plus statutory interest, which recommendation is adopted by the court.

IT IS THEREFORE ORDERED that judgment be and the same is entered for the plaintiff for

twenty thousand nine hundred sixty dollars and forty-three cents ($20,960.43), plus statutory interest.

BY THE COURT

/s/ Daniel M. Friedman
DANIEL M. FRIEDMAN
Chief Judge

APPENDIX C

Internal Revenue Code of 1954 (26 U.S.C.):

SEC. 611. ALLOWANCE OF DEDUCTION FOR DEPLETION.

(a) *General Rule.*—In the case of mines, oil and gas wells, other natural deposits, and timber, there shall be allowed as a deduction in computing taxable income a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under regulations prescribed by the Secretary. * * *

* * * * *

SEC. 613. PERCENTAGE DEPLETION.

(a) *General Rule.*—In the case of the mines, wells, and other natural deposits listed in subsection (b), the allowance for depletion under section 611 shall be the percentage, specified in subsection (b), of the gross income from the property excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. Such allowance shall not exceed 50 percent of the taxpayers' taxable income from the property (computed without allowance for depletion). * * * In no case shall the allowance for depletion under section 611 be less than it would be if computed without reference to this section.

* * * * *

Treasury Regulations on Income Tax (1954 Code) (26 C.F.R.):

§ 1.611-1. *Allowance of deduction for depletion.*

(a) *Depletion of mines, oil and gas wells, other natural deposits, and timber*—(1) *In general.* Section 611 provides that there shall be allowed as a deduction in computing taxable income in the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion. * * * In the case of other exhaustible natural resources the allowance for depletion shall be computed upon either the adjusted depletion basis of the property (see section 612, relating to cost depletion) or upon a percentage of gross income from the property (see section 613, relating to percentage depletion), whichever results in the greater allowance for depletion for any taxable year. In no case will depletion based upon discovery value be allowed.

* * * * *

(b) *Economic interest.* (1) Annual depletion deductions are allowed only to the owner of an economic interest in mineral deposits or standing timber. An economic interest is possessed in every case in which the taxpayer has acquired by investment any interest in mineral in place or standing timber and secures, by any form of legal relationship, income derived from the extraction of the mineral or severance of the timber, to which he must look for a return of his capital. For an exception in the case of certain mineral production payments, see section 636 and the regulations thereunder. A person who has

no capital investment in the mineral deposit or standing timber does not possess an economic interest merely because through a contractual relation he possesses a mere economic or pecuniary advantage derived from production. For example, an agreement between the owner of an economic interest and another entitling the latter to purchase or process the product upon production or entitling the latter to compensation for extraction or cutting does not convey a depletable economic interest. Further, depletion deductions with respect to an economic interest of a corporation are allowed to the corporation and not to its shareholders.

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